DAY TRADING THE FX MARKET : A different approach to the pound

Opening-range breakout techniques have long been favorites of intraday stock index traders. A similar technique can be used in the currency market to capitalize on price moves in the British pound.

BY KRISTIAN KERR

Day trading the foreign currency (forex, FX or interbank) market is definitely one of the more challenging endeavors an aspiring trader can pursue. The higher degree of leverage (as high as 50:1 or 100:1) available in this market can increase profits, but it equally accelerates losses.

This makes the issue of trade timing and selection that much more critical to success. Because of the lack of volume data in the spot currency market (i.e., there are no Level I or II quotes, or time and sales data), newer traders will find they will need to develop much more disciplined strategies that rely less on broader market dynamics and more on raw price action and individual market "micro structure."

The "Big Ben" strategy exemplifies this approach. It is a day-trading technique that takes advantage of the shift from trading from one market center to another in the 24-hour forex trading environment.

For more background information on currency trading, see "The forex market" on the opposite page.

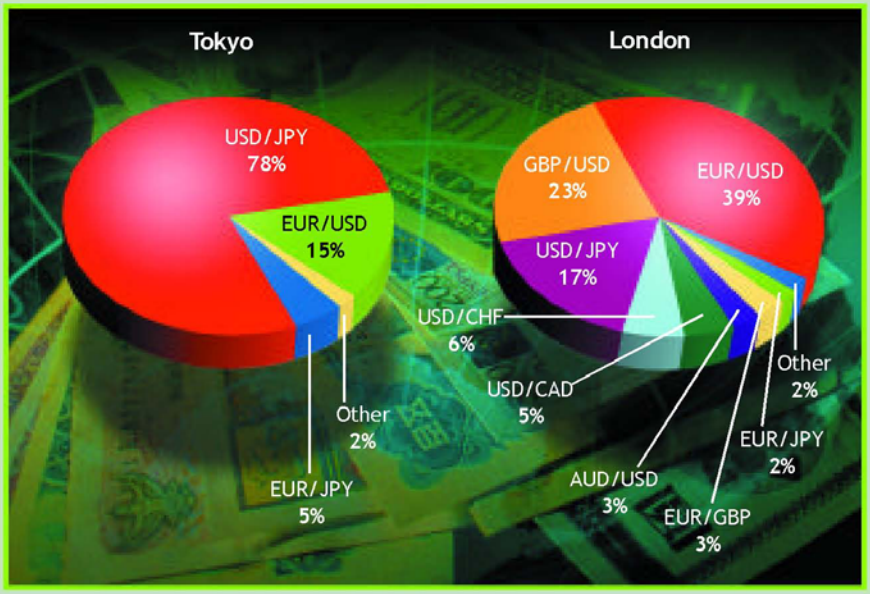
The Big Ben strategy

Big Ben is a currency-specific trading strategy designed to capture the first directional intraday move that often occurs within the first few hours after the Frankfurt/London market openings, which begin at approximately 1 a.m. ET.

The strategy works best with the British pound/U.S. dollar (GBP/USD) rate. Because this currency rate trades lightly outside of London trading hours, the surge in trading every morning in the U.K. gives it a "real" market opening, which the strategy looks to exploit. Figure 1 shows pound/dollar trading is virtually nonexistent during Asian trading hours. When London opens, however, the pound/dollar accounts for nearly one-quarter of

FIGURE 1 — MOST ACTIVE PAIRS BY MONEY CENTER

The pound/dollar currency pair barely trades during Austral-Asian trading hours (left, 4 p.m. - 3 a.m. ET), leading to a more emotional and chaotic open when European trading desks enter the picture. This creates an ideal situation for day traders.



Source: Bank for International Settlements (BIS)

VISIT…

all forex trading. Currency rates with more continuous, 24-hour trading will have less of a distinct open/close as they pass through the different money centers. For example, the dollar/yen rate (USD/JPY), which dominates forex activity during Asian trading hours (78 percent of volume), still accounts for 17 percent of trading during European hours.

Before explaining the specific logic behind the methodology, let's take a look at what needs to occur for a trade to set up.

The rules

The following rules are for short trades, but the strategy can be reversed to trade on the long side.

Setup:

1. The pair makes a new range low at least 25 pips (a pip is the forex equivalent of a tick, or minimum price fluctuation) below the opening price after the early Frankfurt/London trading in the GBP/USD rate begins around 1 a.m. ET.

2. The pair then reverses and trades 25 pips or more above the opening price.

3. The pair then reverses once again to trade back below the intraday low established in step 1.

4. Sell a breakout (at least seven pips) below the London low.

5. Once filled, place an initial protective stop no more than 40 pips above the entry price.

6. After the market moves lower by the distance between the entry price and the stop, cover half the position and trail a stop on the remainder.

These simple rules position you to profit from common behavior that can occur in the pound/dollar when the London/European market opens.

The logic

As mentioned, the pound/dollar rate tends to have lower trading volume outside European/London trading hours because the majority of GBP/USD spot deals are worked through U.K. and European dealers. This gives the European/British interbank community

continued on p. 34

Glossary

Cable: Term used to describe the exchange rate between the U.S. dollar and the British pound.

Interbank rate: The rate at which the major banks (Deutsche, Citibank, Bank of Tokyo) trade in foreign exchange.

Pip (points): Stands for "Point in Percentage," and is the smallest amount an exchange rate can move, typically .0001.

Turnover: The monetary value of volume traded.

Spot market: A market in which commodities, securities or currencies are immediately delivered.

Sterling: Another term for the British pound.

DailyFX.com has a full currency glossary at http://www.dailyfx.com/education_glossary_a.html.

The Forex market

The popularity of foreign exchange trading (Forex, or FX) has accelerated rapidly in recent years as the prospect of 24-hour, high-leverage, highly liquid trading (more than $1.5 trillion in daily turnover) has caught the interest of many traders.

Previously, access to this market had been restricted to corporations, hedge funds, large Commodity Trading Advisors and other institutional investors. However, with the ascendancy of online trading, many firms have opened up the "cash" currency market to individual traders, providing leveraged trading as well as full-feature execution platforms, charts and real-time news.

Unlike the U.S. currency futures markets, which have fixed daily trading hours, the Forex market is a seamless, 24-hour market. Trading occurs between large banks (which is why Forex is sometimes referred to as the "interbank" market), with numerous broker-dealers providing access to this market for individual traders. At 2 p.m. ET each Sunday, trading begins as markets open for the week in Wellington, New Zealand, followed by Sydney and Singapore. At 7 p.m. ET the Tokyo market opens, followed by London at 2 a.m. and, finally, New York at 8 a.m. This overlapping movement of currency trading among market centers allows traders to react to news immediately, and also provides the added flexibility of determining their trading schedules. If important overseas news occurs while the U.S. currency futures markets are closed, the next day's opening could be a wild ride.

Many (but not all) currency broker-dealers do not charge outright commission fees to individual traders. Instead, they profit from the bid-ask spread they set. As a result, many currency firms promote their low spreads rather than their low commission rates. Whether this is a good deal or not depends on the size of the spread in a given currency.

Quoting currency pairs

The way currencies are quoted against each other can initially seem a little confusing. Basically, there are two rules of thumb – and three exceptions to the first rule.

continued on p. 34

FIGURE 2 — BIG BEN

This is a textbook example of the Big Ben strategy. Stops to the downside are immediately taken out when the Frankfurt market opens. The market quickly reverses and triggers upside stop orders when London enters the picture. The pair is now free to make the first real directional move of the day and falls 90 pips before buyers step in.

Source: FX Trek

tremendous insight into the currency pair's actual supply-demand picture.

The Big Ben trade sets up when interbank dealing desks use this intelligence to trigger stops on both sides of the market, resulting in new intraday highs and lows. Once these orders are cleared from the books, the market is primed for its first real directional move of the day, which is what the strategy is designed to capture.

The logic behind this trade should be familiar to S&Pfutures traders, as it is similar to many opening-range breakout strategies used to capitalize on the first real move of the day after the cash stock market opens in New York.

FIGURE 3 — WIDE-RANGE VARIATION

The market dropped a great deal after the London "open" (the second vertical line), but a short trade opportunity still existed because the setup criteria were still valid. This kind of action is typically associated with wide opening ranges.

Source: FX Trek

Trade examples

Figure 2 shows a prototypical Big Ben trade on a five-minute chart. The first vertical line marks midnight ET. The second vertical line denotes the Frankfurt open and the third line shows when London players begin entering the market.

When the Frankfurt market opened, the pound/dollar first moved lower, taking out any nearby sell stops. Within 15 minutes of London entering the picture, however, the market reversed to the upside. The pair was now free to make the first real directional move of the day, and it fell 90 "pips" before buyers stepped in.

Figure 3 illustrates a variation of the Big Ben strategy that commonly occurs when there is an abnormally wide opening range. In this case, the pound traded up 26 pips after the London open to 1.8583, establishing the top of its range. It then came under pressure and sold off 65 pips to make a low of 1.8518 (horizontal line). Next, the currency traded up 50

TABLE 1 — CURRENCY QUOTES

The bottom row of Table 1 is an example of a so-called cross-currency rate, which is any currency rate not involving the dollar. To figure out which currency to buy or sell, look at how it's denominated on the quote board or on the chart. If the denomination is ABC/XYZ, an appreciation of ABC will result in higher quotes and an uptrend on the chart, and consequently a depreciation of XYZ.

What's charted	Denomination	Uptrend in chart means
JPY against USD	USD/JPY	Stronger dollar
CHF against USD	USD/CHF	Stronger dollar
Canadian dollar (CAD) against USD	USD/CAD	Stronger dollar
USD against GBP	GBP/USD	Weaker dollar
USD against AUD	AUD/USD	Weaker dollar
USD against EUR	EUR/USD	Weaker dollar
Any other currency (XYZ) against USD	USD/XYZ	Stronger dollar
XYZ against GBP, AUS or EUR	Example: GBP/XYZ	Stronger pound

The forex market *continued from page 33*

Rule No. 1: All currency rate quotes are expressed as units per dollar. For example, the rate between the Japanese yen (JPY) and the U.S. dollar (USD) is expressed as 102.94 Japanese yen per dollar. The technical term for this is that USD is the "base currency" against which JPY is quoted.

A higher quote, such as 103.62, means that the dollar has appreciated in value compared to the yen, because it now takes more JPY to buy the same amount of USD. When charted, this means that a continuously stronger dollar will result in an uptrend on the chart. If you believe USD will continue to trend higher, which means JPY will trend lower, you should sell JPY.

The exceptions to the first rule are the British pound (GBP), Australian dollar (AUD) and European Currency Unit (EUR). These three currencies are the base currencies against the USD. When rates between the USD and any of these currencies are charted, a continuously stronger dollar will appear as a downtrend on the chart. If USD has appreciated relative to GBP from yesterday to today, today's quote between GBP and USD is lower than yesterday's quote. If you believe USD will continue to trend lower, and consequently GBP to trend higher, you should sell GBP.

Rule No. 2: All quote denominations are backwards with the base currency stated first, so that the quote between, for example, the Swiss franc (CHF) and USD is denominated as USD/CHF, or the quote between USD and EUR is denominated EUR/USD. Table 1 summarizes these relationships.

pips before reversing and plunging below the former low. In this case, a trader could still justify entering a position, since the basic principles behind the trade were still present.

The Big Ben currency day-trading strategy allows you to limit initial risk and capture good moves early in the London trading session. The product of years of watching the currency markets, the approach is based on the workings of the global forex market and attempts to exploit its structure.

For information on the author see p. 8.

Share the wealth

You can invite your friends and colleagues to download a free copy of *Currency Trader* magazine. Just follow these steps.

1. Click the *Send to Friend* button on the top toolbar within Zinio Reader.

2. In the window that appears, enter the email address of each person with whom you'd like to share *Currency Trader*.

3. Add a personal message if you'd like.

4. Click *Send Now*. We'll send an email with your greeting and simple instructions about how to download a free copy of *Currency Trader*.